

## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

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### **Chapter 11 Earnings & Profits And Dividends**

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#### ***References:***

R&TC §25110(a)(6) - (formerly §25110(a)(7))  
IRC §312  
IRC §964  
Treas. Reg. §1.964  
R&TC §24402, 25106 and 24411

#### ***Training Objectives:***

By the end of this section you will be able to:

1. Determine how to compute E&P for Federal purposes;
2. Determine E&P of Controlled Foreign Corporations; and
3. Compare Federal and State methods for computing E&P. Understand the ordering of RTC §24402, 25106 and 24411 pertaining to dividend deductions.

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### **a. Introduction**

Congress has never provided a statutory definition of earnings and profits (E&P). Instead, a definition has developed over the years from a collection of court cases, revenue rulings, and administrative decisions.

Earnings and profits is an economic concept meant to reflect what a corporation will have available for distribution to stockholders as a dividend at any specific time. A correct computation of E&P is necessary to determine the tax treatment of corporate distributions (i.e. dividend, return of capital, or capital gain).

In general, E&P of a corporation included in the waters-edge combined report is computed by starting with net income after state adjustments (line 18 of Form 100) and:

- adding nontaxable income (Intercompany dividends, IRC Section 1032 gains),
- adding artificially created deductions (dividend received deductions), and
- deducting nondeductible expenses (federal income tax).

**NOTE:** You can also compute E&P by starting with federal taxable income (line 28). The current E&P of a domestic corporation computed for state purposes will generally be the same as the amount computed for federal purposes. (If you choose to use line 28 as a starting point, make this clear in your computation.)

For Federal purposes the importance of E&P in the international area can be demonstrated by the effect it has on the following:

- Subpart F Income - taxable as a deemed dividend to the extent of the shareholder's pro-rata share of its current E&P.
- Indirect Foreign Tax Credits- E&P is a significant factor used to compute the deemed paid credit under IRC Sections 902 and 960.

For State purposes the importance of E&P can be demonstrated by the effect it has on the following:

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- Dividends and deductions - E&P is necessary to determine the correct amount of dividends and the dividend-received deductions allowed under R&TC Sections 24402, 24410, 25106 and 24411.
  - Controlled Foreign Corporations (CFCs) - E&P is required to determine the income includible in a water's-edge combined report for CFCs with Subpart F income.
  - Foreign Investment Interest Offset - E&P is required to determine the amount of foreign and domestic investment for purposes of determining interest expense attributable to foreign investment.

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### ***b. E&P To Be Determined On A Separate Company Basis***

It has been determined in the Appeal of Young's Market Company, Cal. Bd. of Equal., November 19, 1986, that earnings and profits are to be computed on a **separate company basis**. Income apportioned to a member of a unitary group by formula cannot form the basis for determining that entity's earnings and profits.

**NOTE:** The SBE's decision in Young's Market Company was upheld by the California Court of Appeals. However, the Court of Appeals decision is not citable because it is an unpublished decision. The Board of Equalization decision is citable.

As discussed above, the purpose for computing E&P is to determine the amount of Subpart F income to include in the water's-edge combined report, the amount of dividends and dividend deductions allowable under R&TC §24402, §24410, §25106, and §24411, the foreign investment interest offset, and the correct treatment of corporate distributions.

Remember, E&P is computed on a corporation by corporation basis using separate accounting and arms-length prices for all intercompany transactions.

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### *c. General Overview - Federal E & P*

To determine the proper treatment of a corporate distribution, you must first compute E&P. IRC Section 316(a) states that any **distribution of property** is a dividend if:

- made out of earnings and profits of the taxable year, or
- made of earnings and profits accumulated since February 13, 1913.<sup>1</sup>

**Property** is defined under IRC §317(a) as money, securities, and any other property except stock in the corporation making the distribution or rights to acquire such stock.

Therefore, before a dividend can be determined, current and accumulated earnings and profits must be calculated.

Current earnings and profits are computed by making certain adjustments to taxable income. The use of taxable income as the starting point for the E&P computation is recommended by the IRS in Revenue Procedure 75-15. (For California purposes, start with net income after state adjustments, determined on a **separate company basis**.)

**Exhibit 11A** lists some common adjustments to be made to compute current E&P.

**Exhibit 11B** lists some common adjustments to be made to compute accumulated E&P.

The calculation of current E&P is made at the end of the taxable year without regard to distributions made during the year. Once current E&P is calculated, it is proratably applied to distributions made during the taxable year. The distributions not absorbed by current E&P are applied in a chronological order to the accumulated E&P on a LIFO basis. All distributions made by a corporation to its shareholders of money, property, and obligations of the distributing corporation, will reduce E&P, but **not below zero**.

A distribution received is taxable as follows:

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- that portion which does not exceed E&P (current and accumulated) is a dividend and is includible in gross income.<sup>2</sup>
  - that portion which is not a dividend is applied against and reduces the adjusted basis of the shareholder's stock as a return of capital and is not taxable.<sup>3</sup> **NOTE:** There are state and federal differences for computing the basis of a subsidiary's stock when a consolidated 1120 return is filed. Federal regulations require the basis to be adjusted by the E&P of the subsidiary (Treas. Reg. 1.1502-32(b)). The state is not in conformity with the federal consolidated return regulations (Sections 1.1501 - 1.1552). The purpose of combined reporting and apportionment is to determine the income earned within California. A combined report does not consolidate the affiliated corporations. Also, per IRC §961, a domestic parent will increase its basis in a CFC by subpart F deemed dividends. Basis is reduced when it receives a dividend that is not included in federal taxable income because of §959. California has not conformed to IRC §961 or §959. See also MATM 6095.
  - to the extent the distribution exceeds the adjusted basis of the stock, it is treated as a capital gain from the sale or exchange of property.<sup>4</sup> Capital gain distributions do not qualify for dividend-received deductions under Sections 25106, 24402, 24410, or 24411.

### EXERCISE 1

The Allen Corporation had accumulated E&P of \$1,000 on January 1, 1992. For 1992, its current earnings and profits were \$5,000. A distribution of \$20,000 was made to its sole shareholder on December 31, 1992. The shareholder's basis in Allen Corporation stock before the distribution is \$20,000. Compute the shareholder's dividend income and return of capital for 1992.

<b>Answer:</b>	Dividends	= \$ 6,000
	Return of Capital	= \$14,000

Computed as follows:

Distribution	\$20,000
Amount taxable as dividend (E&P)	<u>6,000</u>
Return of Capital	\$14,000

The taxpayer's new basis in the stock would be \$6,000 (20,000 - \$14,000).

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### EXERCISE 2

Bacone Corporation is a calendar year cash-basis taxpayer.

- a. Using the following facts, compute Bacone's current E&P for 1992.
- Cash distribution to the shareholder on July 1 was \$18,000. The adjusted basis of the shareholder's stock was \$10,000 .
  - Tax exempt income received during the year was \$5,000.
  - Bacone's federal income tax was \$2,550. (The tax was paid in 1993).
  - Net income after state adjustments for 12/92 is \$20,000. (line 28 of the 1120 is \$15,000.)

**Answer:** Current E&P = \$20,000

Current E&P is initially computed at the end of the year, without reduction by current year distributions. Thus, the distribution was disregarded. The Federal tax liability was paid in the next year by a cash basis taxpayer; therefore, the payment has no effect on current E&P for 1992.

- b. Compute the shareholder's dividend income and return of capital for 1992 assuming Bacone Corporation has no accumulated E&P.

**Answer:** Dividend Income = \$18,000

Current E&P from item a is \$20,000. Therefore, the full distribution of \$18,000 is taxed as a dividend.

### EXERCISE 3

What are your answers assuming the same facts in Exercise 2, except that Bacone is an accrual basis corporation?

**Answer, 3a:** Current E&P = \$17,450

	FEDERAL	CALIFORNIA
Taxable income	\$ 15,000	\$ 20,000
Add: Tax Exempt interest	5,000	

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Minus: FIT accrued	<u>2,550</u>	<u>2,550</u>
Current E&P	\$ 17,450	\$ 17,450
Answer, 3b:		
Dividend Income		<u>\$ 17,450</u>
Return of Capital		<u>\$550</u>
Distribution		\$ 18,000
Dividend (limited to current E&P)		<u>- 17,450</u>
Return of Capital		<u>\$550</u>

### EXERCISE 4

Caldon Corporation received distributions during 1990 from Mighty Corporation. Using the following facts, compute Caldon Corporation's dividend, return of capital, and capital gain.

Mighty Corporation's current E&P	\$15,000
Mighty Corporation's accumulated E&P	\$20,000
Cash distribution to Caldon on 6/1/90	\$22,000
Cash distribution to Caldon on 12/31/90	\$26,000
Caldon's adjusted basis of Mighty's stock	\$10,000

#### Answer:

Taxable Dividend =	\$35,000 (Total E&P - \$15,000 + \$20,000)
Return of Capital =	\$10,000 (Adj. Basis cannot be reduced below 0)
Capital Gain =	\$3,000 (The excess distribution after reduction to basis)

Total Distributions during income year	\$48,000
Current E&P	\$15,000
Excess of distribution over current	\$33,000

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E&P	
Accumulated E&P	\$20,000
Excess of distrib. Over accumulated	\$13,000
E&P	
Adj. Basis of Stock	\$10,000
Excess of distrib. over basis of	\$3,000
Stock	

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### **d. Common Pitfalls**

There are many things to consider when making adjustments to E&P. The following are just a few to be careful of:

- Life Insurance - The corporation that pays for policies on its officers for which it is a beneficiary reduces E&P by the amount of the payments but then increases it by the cash surrender value. When the corporation receives benefits from the policy, E&P for the year should be increased only by the excess of the proceeds over the cash value.<sup>5</sup>
- Depreciation/Gain(Loss) - Because E&P may be reduced by straight line depreciation only, a dual basis for assets is created.<sup>6</sup> Usually salvage value must be subsequently determined for assets depreciated using an accelerated method in order to calculate E&P properly. Remember that when disposing of such an asset, the gain or loss will have to be adjusted in order to determine the effect of the transaction on E&P. Also, if the corporation deducted amounts under IRC Section 179, E&P should be reduced by the deduction ratably over a five-year period.<sup>7</sup>

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### Example 1:

An asset was purchased at a cost of \$40,000 three years ago. It was depreciated using an accelerated method. The accumulated depreciation expense is \$30,000. Accumulated depreciation using straight line would have been \$24,000. The asset was subsequently sold for \$15,000. The required adjustment to compute E&P would be to subtract \$6,000 from taxable income. The computation follows:

Adjustment to E&P	Tax. Income	E & P
Cost	\$40,000	\$40,000
Depreciation	\$30,000	\$24,000
Adjusted Basis	\$10,000	\$16,000
Sales Price	\$15,000	\$15,000
Gain (Loss)	\$5,000	(\$1,000)
Adjustment =	(\$6,000)	

The reason the adjustment is a negative \$6,000 is first you must take out the tax gain of \$5,000 from E&P, then account for the loss. Also please note that the adjustment is not shown net of tax effect, as it might be for financial statement purposes (i.e. an extraordinary item).

Remember, E&P is a tax concept; while it may resemble retained earnings it is **not**.

- Tax Credits - Since tax credits reduce tax liability, thereby increasing the economic position of the firm, an adjustment for credits must be made. If the corporation has excess credits for federal purposes that it can carryback to a previous year, then the adjustment is made in the year they arise since this is the time the corporation receives an economic benefit. When credits must be carried forward, the corporation will not receive an economic benefit until they are used.<sup>8</sup>
- Corporate Reorganizations - When a subsidiary is liquidated or two companies merge, the effect is to create one economic enterprise. This

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concept is reflected by IRC § 381 and regulations thereunder. This section applies to liquidation of subsidiaries (to which IRC § 332 applies) and most reorganizations (with the exception of certain 'D' type reorganizations). Under IRC § 381, the acquiring corporation inherits the target or transferor's attributes, such as E&P, and to a limited extent, NOL carryforwards. The attributes are considered to be inherited on the date of the transfer or reorganization, and credits and NOLs from prior periods are not applied.

- Consolidated Returns - In general, the corporations included in a consolidated 1120 return must compute their E&P on a separate company basis, but Treas. Reg. §1.1502-33 requires "tiering" adjustments whereby the E&P of an upper tier corporation will include the E&P of lower tier subsidiaries. Special rules are also available for determining how to allocate the group's federal tax liability for purposes of computing federal E&P. (See Section 1552 and Rev. Ruling 73-605.) California has not conformed to Section 1552. Per Private Letter Ruling 8524043, the IRS opined that the law relied on in Rev. Rul. 73-605 is a principle of general application and not dependent solely upon the application of the consolidated return regulations. (PLR 8524043 dealt with the allocation of a foreign tax liability between foreign subsidiaries of a U.S. company. In the ruling, the IRS applied the theory underlying the §1552 regulations, even though those regulations do not apply to foreign subsidiaries). Accordingly, we will utilize these rules (Section 1552 and Rev. Rul. 73-605) in determining how to allocate federal income tax for purposes of computing California E&P. Any tiering adjustments included in a corporation's federal E&P computation are not applicable for California.
- Corporate Distributions - This can be a very complex area. Each type of distribution is considered separately, then combined to produce a net reduction or net increase to E&P.
  - Corporation Distributions: Distributions of cash or property reduces E&P by the FMV of the property.<sup>9</sup> Any liabilities transferred with the property reduces the reduction to E&P.<sup>10</sup>
  - Corporation Issues Own Stock: If a corporation issues stock to its shareholders, E&P is not reduced unless the stock distribution (1) is in lieu of money or property, (2) is a disproportionate distribution, (3) results in receipt of preferred stock by some common shareholders and common stock to other common shareholders, (4) is a distribution on preferred stock, or (5) is a distribution of convertible preferred. If one of these conditions is met, the issuance is treated as a distribution of property.<sup>11</sup>

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- Bargain Sale Property: If a corporation sells property to a shareholder below its fair market value, the corporation has made a constructive distribution to the shareholder/purchaser. The difference between the FMV and sales price is treated as a gain to the corporation (thus increasing E&P) and a dividend to the shareholder (which reduces E&P).<sup>12</sup> The adjustment to E&P should only be the difference between the FMV and the sales price. (The difference between the sales price and basis should have already been included in income.)
  - Corporation distributes appreciated property: If appreciated property is distributed by a corporation, the distributing corporation will recognize gain in the amount of the fair market value over basis. E&P should be increased by the amount of this gain. The distribution will then decrease E&P by the amount of the FMV of the property.<sup>13</sup>
  - Adjustments to E&P to More Accurately Reflect Economic Gain and Loss - IRC Section 312(n) lists certain adjustments to be made to E&P with respect to:
    - construction period interest,
    - intangible drilling costs and mineral exploration and development costs,
    - LIFO inventory adjustments,
    - installment sales,
    - the completed contract method, and
    - certain stock redemptions.
  - Dividend and Dividend Received Deductions - Dividend received deductions are added back to E&P. Intercompany dividends and other tax free dividends received increase E&P unless the distribution is a return of capital.<sup>14</sup>

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### ***e. Earnings And Profits Of Foreign Corporations***

#### ***1. Foreign Corporations Other Than CFCs***

The determination of E&P of foreign corporations (which are not CFCs) is much the same as for U.S. based corporations.<sup>15</sup> The main exception to this rule is for corporations with US source income that is less than 20% of gross income from all sources (which includes the majority of the foreign corporations). For these corporations, adjustments for depreciation do not apply (for E&P layers accumulated prior to 1986, adjustments for LIFO inventory and the completed contract method of accounting were also not applicable).<sup>16</sup>

#### ***2. E&P Of Controlled Foreign Corporations***

For federal purposes, there are several different methods of computing E&P depending on the purpose of the computation.<sup>17</sup> For state purposes, only one federal method (Section 964) is relevant since the CFC partial inclusion ratio set forth in §25110(a)(7) (renamed §25110(a)(6) effective January 1, 1996) looks to E&P as defined in IRC §964.

For purposes of IRC Sections 951 through 964 (Subpart F), Treas. Regulation Section 1.964-1(a) provides the general rule that the earnings and profits of a foreign corporation must be computed substantially the same as if the corporation were a domestic corporation. The corporation must:

- Prepare a profit and loss (P&L) statement from the books of account regularly maintained by the corporation for accounting to its shareholders;<sup>18</sup>
- Make adjustments necessary to conform the statement to U.S. accounting standards (G.A.A.P.);<sup>19</sup>
- Make further adjustments to conform the statement to U.S. tax concepts;<sup>20</sup>
- Translate the adjusted statement into U.S. Dollars;<sup>21</sup> and
- Adjust the amount of profit or loss shown on the translated statement to show any exchange gain or loss.<sup>22</sup>

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No accounting or tax adjustment provided in (2) or (3) is required unless it is material. Whether an adjustment is material depends on facts and circumstances.

These requirements are very similar to CCR § 25106.5-3 (formerly 25137-6), except the state regulation does not require a translation gain or loss.

The computation of E&P for CFCs (as defined in §957) was modified by the Tax Reform Act of 1986. The tax reform act added Subpart J to the IRC (Sections 985 through 989). The purpose of Subpart J was to address certain foreign currency transactions and to provide better rules for translating foreign financial statements.

This will be covered in detail in Part 3 of Chapter 11(e), Water's-Edge Manual. The new rules apply to tax years beginning after 1986. The rules for translating financial statements are as follows:

### ***A. Accounting Adjustments (Pre and Post TRA 86 Rules)***

Generally, P&L statements of foreign corporations are prepared for the U.S. shareholder based on U.S. generally accepted accounting principles (GAAP). If the statements do not follow this pattern, you must adjust the statement by applying GAAP standards. Treas. Regulation Section 1.964-1(b) covers the type of accounting adjustments contemplated, such as:

- Clear reflection of Income - such as matching current income with current expense. For example, an adjustment should be made when an allocation of current income is made for arbitrary reserves.<sup>23</sup>
- Historical Cost - All physical assets, including inventory when reflected at cost are taken into account at historical costs. Depreciation, depletion and amortization allowances are based on the historical cost of the underlying assets.<sup>24</sup>
- Valuation of Assets and Liabilities - Assets and liabilities may not be over or undervalued, even when expressly permitted by foreign law. For example, an adjustment would be required where inventory was written down below market.<sup>25</sup>
- Income Equalization - Generally, reserves for income or expense equalization over more than one accounting period will be adjusted.<sup>26</sup>

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### ***B. Tax Adjustments (Pre and Post TRA 86)***

Next the P&L items must be adjusted to conform to tax accounting standards,<sup>27</sup> such as:

- Accounting Methods- you must follow the provisions of IRC §446,
- Inventories should be shown in accordance with IRC Sections 471 and 472.
- Depreciation computed according to IRC Sections 167.
- Bribes - E&P of a foreign corporation may not be reduced for the amount of any illegal bribe, kickback, or other payment.<sup>28</sup> Therefore, any amount of bribe, kickback or illegal payment would be added back to increase current E&P.
- Foreign Deferred Compensation Plans - Deferred compensation plan payments (but not accruals) reduce E&P. Companies in some foreign countries accrue but do not fund deferred compensation plans until later years. An adjustment to E&P should be made for accruals in excess of payments,<sup>29</sup> since such amounts do not meet the qualifications under IRC §404.

### ***C. Blocked Foreign Income (Pre and Post TRA 86)***

IRC Section 964(b) contains a relief provision where a foreign country blocks actual distributions from a resident corporation because of currency or other restrictions. Under the section, a reduction of a CFC's earnings for purposes of determining Subpart F income is permitted if the income is blocked. Treas. Regulation Section 1.964-2 contains the rules which determine when a CFC's earnings are blocked. Under the regulations, the restriction must be mandatory, not voluntary, and the shareholders must show that they have either exhausted the country's procedures to distribute the corporation's earnings, or show that the use of such procedures would be futile. Once the restriction is removed, the blocked portion of the E&P is added back for the years in which the earnings were derived.<sup>30</sup>

### ***D. Translation into U.S. Dollars (Pre TRA 86 Only)***

For income years beginning before 1/1/87, after making the appropriate adjustments to the P&L statement, it must be translated into U.S. Dollars. The general rules require translating amounts at the "appropriate exchange rate" for the particular translation period.



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Generally, the rate of exchange is determined by either a year end rate (for balance sheets), or the average of end of month rates for the taxable year (for income statements). If those rates fluctuate substantially, a weighted average may be used.

Exceptions to this general rule are as follows:

- Cost of goods sold- the opening inventory may be translated at the same rate as the preceding year's closing inventory figure. The taxpayer may also elect to use the year end rate.
- Depreciation, depletion, and amortization- the taxpayer must use the exchange rate for the period in which the historical cost of the underlying asset was incurred.
- Prepaid expenses and income- the taxpayer may use either the year end rate or the rate of the period the item was paid or received.

### ***E. Unrealized Gain or Loss (Pre TRA 86 Only)***

For income years beginning before 1/1/87, the final step in determining the earnings and profits of a foreign corporation for federal purposes is to calculate the unrealized exchange gain or loss on retained earnings. This amount is included in determining the IRC §964 E&P limitation on Subpart F income and as part of IRC §1248 gains. The unrealized gain or loss is computed as follows:

1. First, translate the year-end balance sheet into U.S. dollars. Then subtract the excess of total assets (in U.S. \$) over total liabilities and paid-in-capital (in U.S. \$), which will equal the year-end retained earnings. (Year-end retained earnings is a plugged amount.)
2. Second, take retained earnings at the beginning of the year (a plugged amount computed in the same fashion as above), and add operating profit for the year and deduct distributions made during the year.
3. The difference between retained earnings computed in step 1. and retained earnings calculated in step 2. is the amount of exchange gain or loss.

The computation is illustrated on **Exhibit 11C** and **Exhibit 11D**.

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### **3. Effect Of Tax Reform Act Of 1986**

The 1986 Tax Reform Act introduced Subpart J (§985 - §989). Its sections provide new rules for foreign currency transactions. With the advent of Subpart J, it was necessary to provide special rules for computing a CFC's E&P. For taxable years beginning after December 31, 1986, a CFC's E&P must be computed using the corporation's "functional currency". Functional currency is a concept introduced in IRC Section 985 and is discussed in more detail in **Chapter 12, Water's-Edge Manual**. For now suffice it to say that the foreign currency translation rules were substantially changed to conform with US GAAP rules in FASB 52.

IRC Section 989 is the definitional section for Subpart J and should be mentioned here. IRC Section 989(c) provides the "appropriate exchange rate" to be used in specific circumstances:

- in the case of an actual distribution of E&P, the spot rate for the date on which the distribution is included in income;
- in the case of an actual or deemed sale or exchange of corporate stock recaptured as a deemed dividend under IRC Section 1248, the spot rate for the date on which the deemed dividend is included in income;
- in the case of any amounts included in income under IRC §951(a) (Subpart F), §551(a) (Foreign Personal Holding Income), or §1293(a), (inclusion of income from a Qualified Electing Fund), the weighted average exchange rate for the foreign corporation's taxable year; or
- in the case of any other qualified business unit of a taxpayer, the weighted average exchange rate for the taxable year of such business unit.

Final regulations were published in the Federal Register on January 25, 1990. Treas. Regulation Section 1.964-1T (to be renamed Section 1.964-1(g)(1)) makes the cross reference to IRC Sections 985, 986 and 989 where applicable. Accordingly, the old regulation sections 1.964-1(d), (providing specified translation rates for income statements and balance sheets into U.S. Dollars); (e) (regarding the translation gain or loss); and (f) (regarding an election to be treated as a domestic corporation) will no longer apply after December 31, 1986.

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### ***4. Earnings Of Controlled Foreign Corporations***

For purposes of determining the percentage of a CFC's income subject to inclusion in the water's-edge combined report, the current E&P of a controlled foreign corporation is determined using IRC Section 964.<sup>31</sup>

The IRC §964 rules apply only for purposes of determining the denominator of the CFC's inclusion ratio. For all other California tax purposes, the CFC's E&P is calculated in accordance with the regular California rules.

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### ***f. Determination Of E&P For California Purposes***

California conformed to IRC §312 effective for years beginning on or after January 1, 1987.<sup>32</sup> (The rules that applied prior to 1987 (Sections 24484 - 24493) were identical to the provisions of IRC §312.)

Theoretically, the concept behind the computation of E&P for California purposes has always been substantially the same as for Federal purposes. However, there are a number of adjustments that should be made if the starting point of the California E&P computation is net income after state adjustments (computed on a separate company basis).

1. Dividends deducted under Sections 24402, 24410, 25106, and 24411 are added back into E&P rather than the "dividends received deduction" added back for Federal purposes.<sup>33</sup>
2. In addition to subtracting Federal income tax liability from E&P, state and foreign income taxes must also be subtracted.
3. During worldwide years, profit from intercompany sales of inventory between members of the unitary group are eliminated from income, and the purchaser takes the related seller's basis in the inventory. For federal purposes, profit from intercompany sales of inventory between U.S. and foreign affiliates is currently recognized and the purchaser gets a "stepped-up" basis in the inventory (e.g. its purchase price). This difference in treatment gives rise to differences in state and federal *taxable income*, but has *no* effect on E&P. (Refer to Chapter 17, Water's-Edge Manual for a discussion of the effects of intercompany transactions on the computation of taxable income.)

As discussed in paragraph Chapter 11(b), Water's-Edge Manual, E&P is determined on a separate company basis. E&P is an economic concept intended to approximate a corporation's power to make distributions which are more than just a return of investment. When a party to an intercompany transaction receives payments from its affiliate in excess of its costs, that amount is available for distribution to its shareholders regardless of whether the profit was eliminated from taxable income. There is no statute, regulation, or other authority which requires elimination of intercompany profits from E&P, and such amounts should *not* be eliminated for purposes of determining E&P. Support for this position is found in *Henry C. Beck Company v. Commissioner*, 433 F2d 309 (1970), aff'm 52 TC 1 (1969).

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### ***g. IRC Section 482 Adjustments***

When adjustments are made under IRC Section 482 between a controlled corporation and its shareholder (the parent), the difference between the actual payment and the arms-length amount must be recharacterized as either a constructive dividend<sup>34</sup> or a capital contribution.

The impact of a §482 adjustment on E&P is explained in the following examples:

#### **Example 2:**

A domestic parent (P) sells inventory to a foreign subsidiary (FS) for \$800. The arms-length price is \$1,000. FS sells this inventory during the year.

#### **Impact on E&P from a 482 adjustment :**

Parent increases its net income and E&P by \$200. FS reduces its income and E&P by \$200. (Cost of goods sold is increased to reflect the arms-length price.)

P is deemed to have made a capital contribution to FS of \$200. (Since FS saved \$200 by not paying the arms-length price, this savings is deemed to be a capital contribution.)

#### **Example 3:**

A domestic parent (P) buys inventory from a foreign subsidiary (FS) for \$1,000 when the arms-length price is \$800. P sells the inventory during the year.

#### **Impact on E&P from a 482 adjustment:**

P increases its net income and E&P by \$200. (Cost of goods sold is decreased to reflect the arms-length price.) P is deemed to have made a capital contribution to FS of \$200. (Since P paid FS \$200 more than the arm's-length price, the excess payment is deemed to be a capital contribution.)

#### **Example 4:**

A foreign parent (FP) sells inventory to its domestic subsidiary (S) for \$1,000 when the arms-length price is \$800. S sells the inventory during the year.

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### **Impact on E&P from a 482 adjustment :**

S's income and E&P are increased by \$200. (Cost of goods sold is reduced to reflect the arms-length price.) S is deemed to have made a \$200 constructive dividend to FP. (Since S distributed \$200 more to FP than the arms-length price, the excess distribution is a constructive dividend). S's E&P is reduced by the constructive dividend. FP's gross receipts are decreased by the \$200 reduction in the sales price of the inventory and increased by the \$200 constructive dividend.

#### **Example 5:**

A domestic parent (P) owns a domestic subsidiary (S) and a foreign subsidiary (FS). FS sells inventory to S for \$1,000 when the arms-length price is \$800. S sells the inventory during the year.

### **Impact on E&P from a 482 adjustment:**

S increases its net income and E&P by \$200. (Cost of goods sold is decreased to reflect the arms-length price.) S is deemed to have made a \$200 constructive dividend to P for the distribution in excess of the arms-length price. This dividend increases P's E&P by \$200 and reduces S's E&P. P is deemed to have made a capital contribution to FS of \$200.

**NOTE:** The constructive dividend in examples 4 and 5 may qualify for deductions under Sections 25106 or 24411.

The above examples deal with sales of tangible personal property. Similar tax consequences will result if non arms-length payments are made for services rendered, use of an intangible, or any other intercompany transaction subject to adjustment under §482.

Under certain circumstances the shareholder can obtain relief from the constructive dividend treatment if the requirements of Rev. Proc. 65-17 are met. This revenue procedure allows the recipient to set up a receivable to the distributor in the amount of the adjustment. Even when Rev. Proc. 65-17 is followed, E&P still must be adjusted. See Chapter 18, Water's-Edge Manual for a detailed discussion of Rev. Proc. 65-17.

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Remember, a federal IRC §482 allocation which would have been a "wash" for state net income purposes during world-wide combined-report years, will still affect the E&P of the corporations involved. Therefore, whenever the IRS or the FTB make a Section 482 adjustment, E&P of the affected parties must be adjusted to reflect the changes to income, tax, and other items.

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### ***h. Sources Of Distributions***

#### ***1. Ordering Of Applicable Dividend Deductions***

A distribution is only considered a dividend to the extent that it is paid out of E&P; distributions exceeding E&P reduce stock basis, and any excess is treated as a capital gain. (See FTB Notice 97-2 regarding potential deferral of the capital gain from excess distributions.) It is important to identify the layer of E&P from which is dividend is paid.

A dividend that is paid from E&P generated in years when the payor and payee were not included in the same combined report cannot be eliminated under R&TC §25106.

The general rule is that distributions are paid from current year E&P first. If the distribution exceeds current year E&P, then it comes out of accumulated E&P on a last-in, first-out (LIFO) basis, starting with the most recent year.

California Code of Regulations Section 24411(i) provides that for purposes of determining the application of RTC Sections 24402, 24410, 24411 and 25106, dividends shall be considered to be paid out of the current year's earnings and profits to the extent thereof and from the most recently accumulated earnings and profits by year thereafter.

This LIFO basis of layering the earnings and profits for dividend distribution purposes is the same methodology used in RTC §24451 (formerly RTC §24495; IRC §316(a)). Accordingly, the normal rules of RTC §24451 apply for purposes of determining which earnings and profits are the source of a given distribution.

Dividends paid by foreign affiliates, not included in the water's-edge group but previously included in the worldwide combined report, will be considered distributed first from current year's earnings and profits. These dividends are not eliminated pursuant to RTC §25106. They are considered qualified dividends and will be subject to the RTC §24411 deduction.



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### Example 6:

Corporation G and its 100% owned subsidiary H were engaged in a unitary business for many years prior to G's 1988 water's-edge election, under which H was excluded from the water's-edge group. For 1987 and prior when H was included in G's worldwide combined report, H had \$1,000 of accumulated earnings and profits. H had earnings and profits of \$100 in 1988. H paid to G a dividend of \$50 in 1988.

### Solution:

The dividend is charged entirely to 1988 earnings and profits since they are the most recently accumulated. Thus the dividend does not qualify for elimination pursuant to RTC §25106. Corporation G will report dividend income of \$50 and the dividend qualifies for a deduction under RTC §24411. The §24411 dividend deduction is discussed in Chapter 13, Water's-Edge Manual.

### Example 7:

If Corporation H paid a dividend of \$200 in 1988 the first \$100 would not be eliminated pursuant to 25106. However, the second \$100, attributed to 1987 and prior earnings and profits would be eliminated. Corporation G will report dividend income of \$200. Of this dividend, \$100 qualifies for a deduction pursuant to §24411. The additional \$100 would be eliminated as an intercompany dividend pursuant to §25106.

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### **2. Partially Included Corporations**

Corporations may be partially included in a water's-edge group's combined report pursuant to RTC §25110(a)(4) (formerly (a)(5)) (effectively connected income in the United States) and 25110(a)(6) (formerly (a)(7)) (controlled foreign corporations with Subpart F income). CCR §24411 provides special rules for treating dividends paid by partially included corporations to other members of a water's-edge group.<sup>35</sup> Dividends paid out of earnings and profits of a year in which the payor was only partially included in the combined report are considered subject to RTC §25106 and/or 24411 based on the ratio of the income included in the combined report to the total earnings and profits for the year.<sup>36</sup>

Example 8:

Assume Corporation J files a water's-edge election which allows it to only partially include foreign Corporation K to the extent of its United States income and factors. Corporation K has current earnings and profits of \$100, \$10 of which relates to effectively connected income included in the water's-edge combined report. Corporation K declares a dividend of \$50. Of the \$50 dividend, \$5 ( $\$50 \times \$10/\$100$ ) is considered to be distributed from intercompany earnings and, therefore, subject to elimination pursuant to RTC §25106. The remaining \$45 is not eliminated. Corporation J will report dividend income of \$50. Of this amount, \$45 is eligible for the deduction pursuant to §24411 (see Chapter 13, Water's-Edge Manual), and \$5 is eliminated pursuant to §25106.

### **3. CFC's With Subpart F Income**

For federal purposes, Subpart F income is includible as dividend income. The dividend is deemed to have been distributed from the controlled foreign corporation, whether or not any distribution is actually made. The amount of Subpart F income is a separately stated item on the Schedule C of the federal 1120. Such deemed dividends go into a "pocket" of earnings and profits referred to as Previously Taxed Income (PTI). Under Section 959 of the Internal Revenue Code, when the corporation makes an actual dividend distribution, such dividends are considered to come first out of PTI (current and accumulated).

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The theory is that since such dividends were already taxed in the year they were "deemed" Subpart F dividends, they cannot be taxed again in the year actually distributed.<sup>37</sup> Dividends paid out of PTI are therefore not included in federal taxable income.<sup>38</sup> The taxpayer should have an M-1 adjustment for these items for income taxable on the books but not includible in the return. These "nontaxable" dividends distributions are also detailed on the federal Form 5471, Schedule J.

California Revenue and Taxation Code has no comparable provisions to Internal Revenue Code §951 through 964. The California "partial inclusion" rule of RTC §25110(a)(6) does not consider Subpart F income a "deemed" dividend. We simply look to the ratio of Subpart F income to earnings and profits to determine the amount of taxable income and factors subject to inclusion in the combined report.

Therefore, for California purposes any Subpart F deemed dividend must be excluded from both current year dividends as well as qualifying base period dividends. Conversely, any **actual** dividends paid out of PTI are subject to inclusion in California income and would be considered dividends for purposes of RTC §24411 and 25106. This includes dividends paid from lower-tier CFCs to higher-tier CFCs. (For an in-depth discussion of the treatment of dividends paid by lower-tier CFCs see Part 4 of Section 9.3(c), Water's-Edge Manual).

PTI distributions from partially included CFCs are a common area for potential audit adjustment. Auditors should be aware of this. The taxable distributions from CFCs identified on the federal return DO NOT always represent the actual amount of distributions received by the U.S. shareholder.

### Example 9:

Corporation L filed a water's-edge election effective January 1, 1988. This would allow L to exclude its subsidiary, Corporation M, except for the fact that M has Subpart F income. Corporation M has total earnings of \$150 in 1988 of which \$100 is attributable to income included in the combined report pursuant to former RTC §25110(a)(7). In 1989 M has total earnings of \$100 of which \$50 is attributable to income included in the combined report pursuant to former RTC §25110(a)(7).

What is the result if Corporation M declares a \$75 dividend in 1989?

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### Solution:

For federal purposes, Corporation L reported subpart F deemed dividends of \$100 in 1988 and \$50 in 1989. Therefore, the \$75 distribution is considered a nontaxable PTI distribution (\$50 from 1989 Subpart F earnings and \$25 from 1988 Subpart F earnings). Although the subpart F income will cause M to be partially included in L's combined report, the subpart F deemed dividends themselves are not taxed by California. A state adjustment is therefore required to include the \$75 actual dividend in California income.

Since \$50 of Corporation M's 1989 earnings are attributable to income included in Corporation L's combined report, \$37.50 ( $\$75 \times \$50/\$100$ ) of the dividend is treated as having been paid from the included 1989 earnings, and \$37.50 is treated as having been paid from the excluded earnings.

Therefore, Corporation L would eliminate dividend income of \$37.50 pursuant to RTC §25106, while the remaining \$37.50 is eligible for the RTC §24411 deduction.

Fully excluded entities that have no current year subpart F income may still have a current year actual distribution that is paid out of PTI from prior year Subpart F income. These can be difficult to spot, so audit should always check for PTI issues if there are CFCs in the affiliated group.

### Example 10:

Corporation A, a U.S. corporation, elected to file on a water's-edge basis. It owns 100% of the stock of Corporation B, a CFC. In 1990, B derived \$10,000 of subpart F income. In 1991, B made a distribution of \$5,000 to A. For federal purposes, A will include a \$10,000 deemed Subpart F dividend in its gross income for 1990. A does not include the \$5,000 actual distribution in its federal gross income for 1991. The distribution is considered to be previously taxed income (PTI) and is not includible in A's gross income for 1991 because the earnings have already been included in A's gross income for 1990, pursuant to Subpart F.

For California purposes, A would include the actual distribution of \$5,000 in its gross income for 1991. The \$10,000, which was recognized as income by A for

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federal purposes will not be reportable to California until it is distributed. (Although the Subpart F income will cause B to be partially included in A's combined report for 1990).

On the 1990 federal return, A would report the \$10,000 subpart F deemed dividend from B on Schedule C. No dividend would be reported on Schedule C of the 1991 federal 1120, but the \$5,000 actual distribution should show up as a Schedule M-1 adjustment.

Although dividends paid out of PTI are generally reported as an M-1 adjustment on the federal return, this is not always the case as taxpayers may report these dividends as an M-2 adjustment. Therefore, a thorough review of both the M-1 and M-2 adjustments should be made in cases where there are CFCs in the affiliated group to make sure that the taxpayer properly included dividend income for California purposes. In addition, dividends reported as income on the California return should be reconciled to total "pre-elimination" dividends reported on the affiliated group's books and in the financial statements to identify possible PTI issues.

Subpart F income is discussed in more detail in Chapter 9, Water's-Edge Manual.

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### *i. Maintenance Of Books And Records*

No statute of limitations pertains to the computation of E&P. The corporate taxpayer should construct and retain, permanently, records sufficient to compute E&P.

**Dividends** - IRC §6042(d) requires corporations to report information regarding the computation of E&P including a specific statement of accumulated E&P. (California has conformed under R&TC §18639 effective for taxable years beginning on or after 1/1/87)

**Depreciation** - Treas. Reg. §1.312-15(d) requires that whenever different methods of depreciation are used for taxable income and E&P purposes, records shall be maintained which show the depreciation taken for E&P purposes each year and which will allow computation of the adjusted basis of the property in each account using the depreciation taken for E&P purposes.

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### *j. Audit Tips*

E&P plays a major part in the determination of the includible income of a controlled foreign corporation in the water's-edge combined report. CCR §25110(d)(2)(F)(ii) describes this in detail.

Generally, the includible amount of income and apportionment factors of the CFC is determined by multiplying the CFC's total income and factors by the ratio of its Subpart F income as defined in IRC §952 to total current E&P as defined in IRC §964. This calculation is covered in **Chapter 9, Water's-Edge Manual**, but a few things should be noted about E&P here.

- The E&P used in this calculation is **current earnings only**; if there is a current deficit, but positive accumulated earnings, it does not matter. None of the CFC's income is included in the combined report.
- The best source for determining foreign E&P is the CFC's **audited income statement**. Be sure you ask for this. Do not be content with any pro forma profit & loss statement done by the CFC for internal purposes.
- IRC §959 provides special ordering rules for maintaining the different "pockets" or history of earnings of the CFC. Under IRC §959, current and accumulated earnings are maintained in the IRC §956 pocket, the Subpart F pocket, and the "other" pocket. This is an exception to the general ordering rule of IRC §316. There are a number of reasons for this. The most important reason for maintaining IRC §959 pockets is to keep track of earnings previously reported as a deemed dividend by the U.S. shareholder(s). Subsequent distributions by the U.S. shareholder(s) then reduce the IRC §956 pocket and Subpart F pocket until exhausted. Such amounts are considered drawn from previously taxed income and are not treated as dividends. These amounts will be not be part of Federal Taxable income and should be listed on the Federal schedule M-1. The auditor needs to be aware of this, identify the distribution, and source the distribution to E&P using State rules. Only after this is done can the auditor determine the tax effect of the distribution, and what dividend deduction rules apply. The effects of IRC §959 are discussed in more detail in **Chapter 9, Water's-Edge Manual**. (California does NOT conform to the §959 rules.)

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### **Other issues to be considered by the auditor:**

- Is the distribution really a dividend or is it a return of capital? There can be material federal/state differences in the amounts of E&P and stock basis.
- Has the E&P been computed correctly?
- Have there been any adjustments that will effect E&P?
- What is the correct amount of dividend subject to the §25106 elimination and the §24411 dividend deduction?



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### ***k. Summary***

A correct computation of E&P is necessary to determine the tax treatment of corporate distributions (i.e. dividend, return of capital, or capital gain).

For Federal purposes the calculation of E&P in the international area is important for determining Subpart F income and foreign tax credits. For State purposes a working knowledge of E&P is necessary to determine the correct amount of dividends and dividend-received deductions allowed under R&TC Sections 24404, 24410, 25106 and Section 24411.

A distribution is only considered a dividend to the extent that it is paid out of E&P; distribution exceeding E&P reduce stock basis, and any excess treated as a capital gain. It is important to identify the layer of E&P from which is dividend is paid.

A dividend that is paid from E&P generated in years when the payor and payee were not included in the same combined report cannot be eliminated under R&TC §25106.

The general rule is that distributions are paid from current year E&P first. If the distribution exceeds current year E&P, then it comes out of accumulated E&P on a last-in, first-out (LIFO) basis, starting with the most recent year.

Determining the correct E&P is also required for determining the includible income of a controlled foreign corporation (when it has subpart F income) and determining the foreign investment subject to the foreign investment interest offset.

The auditor should use the CFC's audited financial statement for determining its E&P. If these are not available, consider using the Federal Form 5471. Be aware, however, that the information may not be as accurate as the information contained in audited financial statements.

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### **Footnotes**

1. IRC §316(a)
2. IRC §301(c)(1)
3. IRC §301(c)(2)
4. IRC §301(c)(3)(A)
5. Rev. Ruling 1954-1 CB114; Tax Management Portfolio 762, III(B)
6. IRC §312(k)
7. IRC §312(a)(b)
8. Rev. Rul. 66-336
9. IRC §312(a)(b)
10. IRC §312(c)
11. IRC §312(d) and Treas. Reg. §1.312-1(d), which refers to §305(b)
12. L.E. Dellinger 32 TC 1178
13. IRC §311(b) and §312(b)
14. IRC §312(f)
15. IRC §964
16. IRC §312(k)(4), §312(n)(8)
17. IRC §902, 951, 960, 964
18. Treas. Reg. §1.964-1(a)(1)
19. Treas. Reg. §1.964-1(a)(2)
20. Treas. Reg. §1.964-1(a)(3)
21. Treas. Reg. §1.964-1(a)(4)
22. Treas. Reg. §1.964-1(a)(5)
23. Treas. Reg. §1.964-1(b)(1)(i)
24. Treas. Reg. §1.964-1(b)(1)(ii)
25. Treas. Reg. §1.964-1(b)(1)(iii)
26. Treas. Reg. §1.964-1(b)(1)(iv)
27. Treas. Reg. §1.964-1(c)
28. IRC §964(a)
29. Tax Management Portfolio #762, III (D)(1)
30. Treas. Reg. §1.964-2(c)(ii)
31. CCR §25110(d)(2)(F)(ii)
32. R&TC §24484 (effective 1/1/87-12/31/92, repealed as of 1/1/93) R&TC §24451 (effective 1/1/93 to date)
33. IRC §312(f)(2)
34. Sammons v. Commissioner, 472 F.2nd (5th Cir. 1972); Loftin & Woodard, Inc.v. United States, 577 F.2nd 1206 (5th Cir. 1978)
35. CCR §24411(i)(2)

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- 36. CCR §24411(i)(2)(B)
  - 37. IRC §959(a)
  - 38. IRC §959(d)